THE PRINCETON REVIEW, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements—(Continued)

Advertising and Promotion

The majority of costs associated with advertising and promotion are expensed in the year incurred. Costs related to producing mailers and other pamphlets are expensed when mailed. Due to the seasonal nature of the business, most advertising costs related to mailers and pamphlets are expensed by the end of the year. Total advertising and promotion expense was approximately $6.5 million, $7.9 million, and $9.4 million for the years ended December 31, 2003, 2002 and 2001, respectively.

Use of Estimates

The preparation of the financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Significant accounting estimates used include estimates for uncollectible accounts receivable, impairment write downs and amortization lives assigned to intangible assets. Actual results could differ from those estimates.

Fair Value of Financial Instruments

For financial instruments including cash and cash equivalents, accounts receivable, other receivables and accounts payable, the carrying amount approximated fair value because of their short maturity. The carrying value of the Company's debt approximated fair value as the interest rates for the debt approximated market rates of interest available to the Company for similar instruments. Securities, available for sale, are publicly traded and are stated at the last reported sales price on the day of the valuation.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentration of credit risk include cash and cash equivalents and accounts receivable arising from its normal business activities. The Company places its cash and cash equivalents with high credit quality financial institutions.

Concentrations of credit risks with respect to accounts receivable are limited due to the large number of entities comprising the payor base, and their dispersion across different states. The Company does not require collateral. At December 31, 2003, one customer accounted for approximately 27% of gross accounts receivable. At December 31, 2002, two individual customers accounted for approximately 19% and 16% of accounts receivable, respectively.

Income Taxes

The Company accounts for income taxes based upon the provisions of SFAS No. 109, *Accounting for Income Taxes.* Under SFAS 109, the liability method is used for accounting for income taxes, and deferred tax assets and liabilities are determined based on differences between financial reporting and tax basis of assets and liabilities.

Income (Loss) Per Share

Basic and diluted net income (loss) per share information for all periods is presented under the requirements of SFAS No. 128, *Earnings per Share.* Basic net income (loss) per share is computed by dividing net income (loss) applicable to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is determined in the same manner as basic net income (loss) per share except that the number of shares is increased assuming exercise of dilutive stock options, warrants and convertible securities. The calculation of diluted net income (loss) per share excludes potential common shares if the effect is antidilutive.

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Notes to Consolidated Financial Statements—(Continued)

During certain of the periods presented, stock options and securities convertible into or exercisable for common stock were outstanding that would be dilutive but were excluded because to include them would have been antidilutive (See Note 15).

Investment in Marketable Equity Securities

The Company has classified its investment in Student Advantage, Inc. common stock as available for sale. Investments classified as available for sale are carried at fair value, with the unrealized gains and losses, net of tax, reported as a separate component of stockholder's equity. The fair value of investments is based on quoted market prices at the end of each accounting period. The cost of securities sold is based on the specific identification method. The accumulated balance as a component of comprehensive loss was approximately $17,000 and $4,000 at December 31, 2003 and 2002, respectively.

Stock options

The Company accounts for the issuance of stock options using the intrinsic value method in accordance with Accounting Principles Board ("APB") No. 25, *Accounting for Stock Issued to Employees,* and related interpretations. Generally for the Company's stock option plans, no compensation cost is recognized in the Consolidated Statements of Operations because the exercise price of the Company's stock options equals the market price of the underlying stock on the date of grant. Had the Company accounted for its employee stock options under the fair-value method of that statement, the Company's net income per share would have been decreased and net loss per share would have been increased to the pro forma amounts indicated:

	Years Ended December 31,		
	2003	2002	2001
	(in thousands, except per share data)		
Net income (loss) attributed to common stockholders, as reported	$ 4,309	$(1,090)	$(14,599)
Total stock-based employee compensation expense determined under fair-value based method for all awards, net of related tax effects	(1,326)	(777)	(415)
Pro forma net income (loss) available for common stockholders	$ 2,983	$(1,867)	$(15,014)
Basic and diluted income (loss) per share, as reported	$ 0.16	$ (0.04)	$ (0.68)
Basic and diluted income (loss) per share, pro forma	$ 0.11	$ (0.07)	$ (0.70)

Prior to the Company's initial public offering, the fair value for these options was estimated at the date of grant using the minimum-value method, which utilizes a near-zero volatility factor. After the Company's initial public offering, these options were valued using a Black-Scholes option pricing model. The following weighted-average assumptions were used under these methods:

	Years Ended December 31,			
	2003	2002	2001	
Assumptions		Black-Scholes Option Pricing Model		Minimum Fair Value Method
Expected life (years)	4.8	5	5	5
Risk-free interest rate	4.5%	4.5%	5.5%	5.5%
Dividend yield	0%	0%	0%	0%
Volatility factor	0.7613	0.7611	1.13	n/a

These option-valuation methods require input of highly subjective assumptions. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because change in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing methods do not necessarily provide a reliable single measure of the fair value of its employee stock options. The effects of applying SFAS 123 in this pro forma disclosure are not indicative of future amounts and additional awards in future years are anticipated. For purposes of pro forma disclosure, the estimated fair value of the equity awards is amortized to expense over the options' vesting period. The weighted average fair value of options granted during the years ended December 31, 2003, 2002 and 2001 was $2.75, $4.74 and $5.73, respectively. As of December 31, 2003, there were 1,790,513 options exercisable with a weighted average remaining contractual life of 7.4 years.

Adoption of New Accounting Pronouncements

In April 2002, the FASB issued SFAS No. 145, *Rescission of FASB Statements No. 4, 44, and 62, Amendment of FASB Statement No. 13, and Technical Corrections.* In most instances, SFAS No. 145 will require gains and losses on extinguishments of debt to be classified as income or loss from continuing operations rather than as extraordinary items as previously required under FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt.* This provision of SFAS No. 145 is effective for fiscal years beginning after May 15, 2002. The Company adopted SFAS No. 145 as of January 1, 2003. Accordingly, the Company reclassified the $3.1 million loss on extinguishment of debt previously classified as an extraordinary item in 2001 to conform to the provisions of SFAS No. 145.

In November 2002, the FASB's Emerging Issues Task Force (EITF) reached a consensus on EITF Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF Issue No. 00-21 addresses revenue recognition on arrangements encompassing multiple elements that are delivered at different points in time, defining criteria that must be met for elements to be considered to be a separate unit of accounting. If an element is determined to be a separate unit of accounting, the revenue for the element is recognized at the time of delivery. The Company recognizes revenue in accordance with EITF 00-21.

In January 2003, the FASB released Interpretation No. 46, *Consolidation of Variable Interest Entities* ("FIN 46"). FIN 46 requires that all primary beneficiaries of Variable Interest Entities ("VIE") consolidate that entity. FIN 46 is effective immediately for VIEs created after January 31, 2003 and to VIEs to which an enterprise obtains an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to VIEs in which an enterprise holds a variable interest it acquired before February 1, 2003. In December 2003, the FASB published a revision to FIN 46 ("FIN 46R") to clarify some of the provisions of the interpretation and defer to the effective date of implementation for certain entities. Under the guidance of FIN 46R, entities that do not have interests in structures that are commonly referred to as special purpose entities are required to apply the provisions of the interpretation in financial statements for periods ending after March 14, 2004. The Company does not have any arrangements with variable interest entities that require consolidation of their financial information into its financial statements. FIN 46 is not expected to have a material impact on the Company's financial statements or liquidity.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* which requires that certain financial instruments with characteristics of both liabilities and equity, including mandatorily redeemable financial instruments, be classified as a liability. Any amounts paid or to be paid to holders of these financial instruments in excess of the initial measurement amount shall be reflected in interest cost. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise shall be effective at the beginning of a company's first interim period beginning after June 15, 2003, except for mandatorily redeemable financial instruments of a nonpublic entity, in which case SFAS No. 150 shall be effective for

existing or new contracts for periods beginning after December 15, 2003. The Company does not expect the adoption of SFAS No. 150 to have any impact on its financial position or results of operations.

Reclassification

Certain balances have been reclassified to conform to the current year presentation.

2. Other Assets

Other assets (current) consist of the following at:

	December 31, 2003	December 31, 2002
	(in thousands)	
Deferred book costs	$ 529	$ 42
Inventories	901	639
Deferred income tax	852	907
Deferred cost of franchise acquisitions	34	29
Products in development	537	57
Other	478	280
	$3,331	$1,954

Other assets (noncurrent) consist of the following at:

	December 31, 2003	December 31, 2002
	(in thousands)	
Capitalized course costs, net of accumulated amortization of $2,405 in 2003 and $1,693 in 2002	$ 4,859	$4,700
Non-compete agreement costs, net of accumulated amortization of $715 in 2003 and $450 in 2002	390	584
Content and software development in progress	745	312
Security deposits	691	555
Loans to officers	1,196	1,117
Customer lists, net of accumulated amortization of $608 in 2003 and $338 in 2001	2,093	2,363
Trademark, net of accumulated amortization of $12 in 2003 and $11 in 2002	326	327
Other	507	—
	$10,807	$9,958

3. Furniture, Fixtures, Equipment and Software Development

Furniture, fixtures, equipment and software development consist of the following at:

	December 31, 2003	December 31, 2002
	(in thousands)	
Computer equipment	$ 5,432	$ 5,474
Furniture, fixtures and equipment	1,529	1,645
Computer and phone equipment under capital leases	1,624	2,120
Automobiles	22	22
Software—third party	2,902	3,490
Software—internally developed	5,685	6,506
Leasehold improvements	4,240	3,988
	21,434	23,245
Less accumulated depreciation and amortization, including $722 in 2003 and $1,456 in 2002 of accumulated depreciation for assets under capital leases	9,626	11,892
	$11,808	$11,353

4. Investment in Affiliates

The Company has an ownership interest of approximately 20% in Student Monitor, LLC, a privately held company. At December 31, 2003 and 2002, the Company's investment in this company was approximately $31,000 and $63,000, respectively.

In February 1999, the Company invested $5,000 for an ownership interest of approximately 48% in Tutor.com, Inc., a privately held startup company. Effective December 31, 1999, as a result of additional third party investments in Tutor.com, Inc., the Company's interest was reduced to approximately 30%. In May 2000, after further third party investments and an additional $1 million investment by the Company, the Company's ownership interest was reduced to approximately 20%. At December 31, 2003 and 2002, the Company's net investment in Tutor.com was $0, as a result of recording its share of Tutor.com losses. Pursuant to an agreement entered into on December 31, 2003, the Company terminated its strategic relationship with Tutor.com. and sold preferred stock it held in Tutor.com for $300,000 in cash. As consideration for the termination of certain strategic agreements and the restructuring of certain rights, the Company received an additional $200,000 in cash and $500,000 in notes. The Company retains a common stock position in Tutor.com, representing approximately 2.5% of its outstanding equity, which is valued at $0.

In 2002 and 2001, the Company invested $130,000 and $270,000, respectively, in SchoolNet, Inc., a privately held education technology solutions company. The Company currently owns approximately 5% of SchoolNet. The Company maintains a strategic marketing relationship with SchoolNet, through which SchoolNet markets and distributes a version of the Company's Homeroom.com product called "Homeroom Inside." As of December 31, 2003 and 2002, the value of the Company's investment in SchoolNet was approximately $356,000, net of an impairment writedown of approximately $344,000 in 2002. The Company has also contracted with SchoolNet to provide Enterprise Resource Planning software that monitors the use of the Homeroom.com Web site.

5. Identified Intangible Assets

Annual pretax amortization for identified intangible assets including customer lists, franchise rights, non-compete agreements and royalty rights, over the next five years is estimated to be as follows:

Year ending December 31,	
2004	$652,000
2005	$448,000
2006	$386,000
2007	$359,000
2008	$351,000

6. Lines of Credit and Long-Term Debt

Lines of Credit

On December 14, 2000, the Company entered into a loan agreement with Reservoir Capital Partners, L.P., Reservoir Capital Master Fund, L.P., Reservoir Capital Associates, L.P., SGC Partners II, LLC, Olympus Growth Fund III, L.P., and Olympus Executive Fund, L.P., providing for a line of credit. The Company incurred approximately $1,103,000 of transaction costs in connection with this loan agreement. Amounts borrowed under the credit facility initially bore interest at an annual interest rate of 13%. Until the termination of the facility, the applicable annual interest rate was to increase by 1% on each anniversary of the agreement. The loan was secured by substantially all of the Company's current and future business assets. In connection with this line of credit, the Company issued warrants for the purchase of Class A common stock to the lenders (see Note 7). During 2001 the Company borrowed $24,691,000, which was fully paid off including all accrued interest on June 22, 2001 with a portion of the Company's proceeds from its initial public offering and the facility was terminated as of that date. In connection with the retirement of this loan, the Company wrote off the remaining deferred financing costs and the unamortized cost of the warrants issued to the lenders resulting in a loss on early extinguishment of debt of approximately $3.1 million.

On March 2, 2001, the Company completed its acquisition of Princeton Review of New Jersey, Inc. and Princeton Review of Boston, Inc. (see Note 12). The Company financed part of this acquisition with notes from the sellers totaling $3,625,000, which was outstanding as of December 31, 2003. This balance is comprised of two notes. The first promissory note of $3,125,000 is payable as to principal in 20 equal quarterly installments beginning with the 17th calendar quarter following the closing date of the acquisition and bears interest at the rate of 8.25% per year, payable quarterly. This promissory note was convertible into common stock at the price per share at which shares of the Company's common stock are sold in its initial public offering for a period of 60 days, beginning on the first anniversary date of the completion of the offering. During this period, the holder of the note had the right to convert 100% or any percentage between 0% and 33% of the unpaid principal amount due under the note into common stock. The second promissory note of $500,000, bears interest at the rate of 8.25% per year, payable on a quarterly basis, and is payable as to the entire principal amount four years from its date of issuance.

On June 18, 2001, the Company acquired the assets comprising the business of T.S.T.S., Inc. (see Note 12). The Company financed part of this acquisition with a note from the sellers in the amount of $1,475,000, which was outstanding as of December 31, 2003. This note is payable as to principal in 10 equal quarterly installments beginning on January 1, 2004 and bears interest at the rate of 8.25% per year, payable quarterly.

On October 1, 2001, the Company completed its purchase of substantially all of the operating assets of Embark.com, Inc. ("Embark") (see Note 12). As part of the assumed liabilities, the Company renegotiated and assumed $3.4 million in indebtedness that Embark owed to Comdisco, Inc.

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("Comdisco"). Amounts outstanding under the loan agreement bore interest at an annual rate of 6.25%. The loan was secured by substantially all of the Company's current and future business assets, including membership interests in its subsidiaries, and was guaranteed by the Company's subsidiaries. The loan agreement contained covenants typical to a secured loan agreement, including covenants requiring the Company to maintain financial ratios relating to total indebtedness to net worth, and covenants that restrict, among other things, the Company's ability to incur additional debt, pay cash dividends, create liens, change its fundamental organization or lines of business, make investments, engage in transactions with affiliates, and engage in certain significant corporate transactions. As of December 31, 2002, approximately $1.4 million of the loan remained outstanding with the entire loan paid in full as of December 31, 2003.

On October 18, 2002, the Company acquired the assets comprising the business of The Princeton Review of St. Louis, Inc. (see Note 12). The Company financed part of this acquisition with a note from the sellers in the amount of $466,500, which was outstanding as of December 31, 2002. This note is payable in two annual installments of $250,000, including interest which is imputed at the rate of 4.8% per year. At December 31, 2003, $228,000 was outstanding under this note, which is due in October 2004.

On July 11, 2003, the Company acquired 77% of Princeton Review of North Carolina, Inc with the balance acquired from the minority shareholders on November 13, 2003. The Company financed part of this acquisition with two notes to the sellers in the amount of $760,000 and $208,000, including imputed interest at 5% per year, which were outstanding as of December 31, 2003. The $760,000 note is payable in annual installments of $80,000, including interest, during 2004 and 2005 increasing to $120,000 in years 2006 through 2010 when the loan is due. The $208,000 note is payable in annual installments of $29,714, including interest, in years 2004 through 2010 when the loan is due.

Capital Lease Obligations

At December 31, 2003, the Company has leased approximately $1.6 million of computer and phone equipment under capital leases, all of which are included in fixed assets (see Note 3).

The annual maturities of notes payable as of December 31, 2003 are approximately as follows:

As of December 31,	Amount Maturing (in thousands)
2004	$ 925
2005	1,645
2006	1,031
2007	735
2008	735
Thereafter	1,004
	$6,075

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Notes to Consolidated Financial Statements—(Continued)

The following is a schedule of the future minimum capital lease obligation payments together with the present value of the minimum lease payments at December 31, 2003:

Year ending December 31,	(in thousands)
2004	$ 454
2005	329
2006	281
2007	40
2008	1
Total	1,105
Less amounts representing interest (effective rate ranges from 6% to 22%)	157
Present value of the minimum lease payments	948
Less current portion of capital lease obligations	393
Long-term portion of capital lease obligations	$ 555

Long-Term Debt

Long-term debt consists of the following at:

	December 31, 2003	December 31, 2002
	(in thousands)	
Notes payable	$6,075	$6,980
Capital lease obligations	948	531
Auto loan	5	11
	7,028	7,522
Less current portion	1,318	1,866
	$5,710	$5,656

7. Stockholders' Equity

Initial Public Offering of the Company's Common Stock

In June 2001, the Company completed its Initial Public Offering in which it sold 5,400,000 shares of common stock at $11.00 per share resulting in net proceeds of approximately $51.9 million. Concurrently, all outstanding shares of Class A common stock and Class B non voting common stock were converted on a one-for-one basis into newly issued common stock.

Issuance of Warrants

On December 14, 2000, the Company entered into a loan agreement with Reservoir Capital Partners, L.P., Reservoir Capital Master Fund, L.P., Reservoir Capital Associates, L.P., SGC Partners II, LLC, Olympus Growth Fund III, L.P., and Olympus Executive Fund, L.P. (see Note 6). As part of the loan transaction, the lenders received warrants initially exercisable for a total of 250,000 shares of common stock at an exercise price of $0.01 per share. The fair value of the 250,000 warrants issued at closing was valued at $2,997,500 using the Black-Scholes option pricing model. This amount was recognized as interest expense over the life of the loan. Such amount was adjusted based upon the initial public offering price resulting in the decrease in the value of the warrants by approximately $250,000.

Simultaneously with the Company's initial public offering in June 2001, these warrants were converted into 249,774 common shares and the unamortized balance was written off when the loan was paid off on June 22, 2001. This resulted in a loss on early extinguishment of debt (see Note 6).

8. Commitments and Contingencies

Advertising Fund

All domestic franchisees are required to pay a monthly advertising fee to the Company, for contribution to an advertising fund, equal to 2% of their franchises' gross receipts, as defined, for the preceding month. In accordance with the terms of the franchise agreements, the Company is required to use all advertising fees it receives for the development, placement and distribution of regional and national consumer advertising, designed at its discretion to promote consumer demand for services and products available from the franchises.

The Company is required to keep separate advertising fund accounting records and to maintain the advertising funds collected from the franchisees in a separate bank account. Franchisee payments to the Company in respect of the advertising fund are recorded in the Company's revenue and the expenses of the advertising fund are recorded in the Company's Selling, General and Administrative Expenses.

Office and Classroom Leases

The Company has entered into various operating leases for its office and classroom site locations. Minimum rental commitments under these leases, including fixed escalation clauses, which are in excess of one year, as of December 31, 2003, are approximately as follows:

Years ending December 31,	(in thousands)
2004	$ 4,968
2005	4,475
2006	4,071
2007	3,569
2008	3,125
Thereafter	5,150
	$25,358

Rent expense for the years ended December 31, 2003, 2002 and 2001 was approximately $7.7, $6.9 and $6.5 million, respectively. These amounts include rent expense for the rental of space on a month-to-month basis, as well as those amounts incurred under operating leases for longer periods. Certain leases provide for early termination without penalty.

The Company has been released from a portion of its rent obligation on certain premises which it is subleasing through 2004; however, in the event of default by the sublessee, it would remain liable for the balance of the rent obligation, which, at December 31, 2003 aggregated approximately $34,000.

Legal Matters

The Company is party to various litigation matters in the ordinary course of its business which, in the opinion of management, will not result in a material loss to the Company.

In June 1996, an author filed a lawsuit against the Company. On May 10, 2000, the lawsuit was settled and the Company paid the author $900,000 cash and issued warrants providing for the purchase of such number of shares of the Company's common stock as is obtained by dividing $1,200,000 by the initial public offering price of the Company's common stock. These warrants were exercisable for an

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Notes to Consolidated Financial Statements — (Continued)

18-month period, beginning with the date of the completion of an initial public offering by the Company, at an exercise price equal to the initial public offering price of the Company's stock. At December 31, 2000, the Company recorded a $300,000 expense for the fair value of the warrants using the Black-Scholes option pricing model. In December 2002, the warrants expired unexercised. In addition, as part of the settlement, the Company's royalty agreement with the author was amended. Under the amended royalty agreement, the publisher pays royalties directly to the author. Should royalties paid under the agreement be less than $200,000 per year through December 31, 2004, the Company is required to pay the difference. No payments to achieve the required minimum were made in 2003, 2002 and 2001.

Co-authorship Agreements

In connection with its publishing agreements, the Company has entered into various co-authorship agreements for the preparation of manuscripts. These agreements require payment of nonrecourse advances for services rendered at various established milestones. The Company's future contractual commitments under the co-authorship agreements for manuscripts not yet delivered as of December 31, 2003 and 2002 are approximately $30,000 and $29,000, respectively. In addition, the co-authors are entitled to a percentage of the future royalties earned by the Company, which are first to be offset against such advances. The total costs incurred under these co-authorship agreements by the Company for advances and royalties were approximately $528,000, $367,000, and $284,000 for the years ended December 31, 2003, 2002 and 2001, respectively.

The expense related to co-author payments is accrued monthly. This expense is adjusted based upon actual expenditures paid to the co-authors. These expenditures are a percentage of the royalties paid to the Company by the publisher. Royalties from the publisher are recorded as revenue with the co-author expenditures recorded as expense.

9. Income Taxes

The (provision) benefit for income taxes consists of the following:

	Years Ended December 31,		
	2003	2002	2001
		(in thousands)	
Current tax (provision) benefit:			
U.S. Federal	$ (112)	$ —	$ —
State	(67)	—	(128)
Foreign	—	(67)	(81)
	(179)	(67)	(209)
Deferred tax (provision) benefit:			
U.S. Federal	(2,217)	575	5,886
State	(857)	228	2,247
Foreign	97	—	—
	(2,977)	803	8,133
Total (provision) benefit for income taxes	$(3,156)	$736	$7,924

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Notes to Consolidated Financial Statements—(Continued)

Significant components of the Company's deferred tax assets and liabilities are as follows at:

	December 31, 2003	December 31, 2002
	(in thousands)	
Deferred tax assets:		
Net operating loss carryforward	$18,108	$19,641
Tax credit carryforwards	112	—
Allowance for doubtful accounts	126	219
Equity compensation	186	198
Capitalized inventory costs	39	33
Deferred rent	500	404
Unrealized losses	162	147
Other	341	360
Total deferred tax assets	19,574	21,002
Deferred tax liabilities:		
Software development costs	(1,140)	(703)
Accumulated amortization	(1,310)	(537)
Accumulated depreciation	(460)	(256)
Total deferred tax liabilities	(2,910)	(1,496)
Net deferred tax asset	$16,664	$19,506

The net deferred tax asset at December 31, 2003 and 2002 is classified in the Company's consolidated balance sheet as other current assets of approximately $852,000 and $907,000 respectively and noncurrent deferred tax assets of approximately $15.8 million and $18.6 million, respectively. As of December 31, 2003, the Company has a net operating loss carryforward totaling approximately $42.9 million which expires in the years 2020 through 2023, and other timing differences which will be available to offset regular taxable income during the carryforward period. The Company believes that the related deferred tax benefit amount will more likely than not be recognized during these periods and, accordingly, no valuation allowance was deemed necessary.

A reconciliation setting forth the differences between the effective tax rate of the Company for the years ended December 31, 2003, 2002 and 2001 and the U.S. federal statutory tax rate is as follows:

	Years Ended December 31, 2003		2002		2001	
	(in thousands)					
U.S. Federal income tax at statutory rate	$(2,537)	34%	$621	34%	$6,208	34%
Effect of permanent differences and other	(121)	1.5%	(14)	(0.7)%	369	2%
Effect of state taxes	(498)	6.7%	129	7.1%	1,347	7.4%
	$(3,156)	42.2%	$736	40.4%	$7,924	43.4%

10. Employee Benefits and Contracts

Fully Insured Partial Funding Medical Plan

Prior to December 31, 2002, the Company provided a fully insured partial funding medical plan for its employees. Under this plan, the Company was liable for medical claims submitted (after the deductible and any co-payment by the employee) up to the amount of $40,000 per employee. Any claims in excess of this amount are covered by the insurance carrier. At December 31, 2002, the Company had no significant unfunded claims. As of December 31, 2002, and based on the number of covered

employees at such date, the maximum annual liability for medical claims for 2002 would be $1.6 million. Beginning January 1, 2003 the company contracted with an insurance provider to provide medical insurance for its employees and under this new contract the Company is not liable for medical claims.

Retirement Plan

The Company has a defined contribution plan (the "Plan") under Section 401(k) of the IRC, which provides that eligible employees may make contributions subject to IRC limitations. Employees become eligible to participate in the Plan after one year of continuous full-time employment. Under the provisions of the Plan, contributions made by the Company are discretionary and are determined annually by the trustees of the Plan. The Company's contributions to the Plan for the years ended December 31, 2003, 2002 and 2001 were $200,000, $199,000, and $159,000, respectively.

Stock Incentive Plan

On April 1, 2000, the Company adopted its 2000 Stock Incentive Plan (the "Stock Incentive Plan") providing for the authorization and issuance of up to 2,538,000 shares of common stock, as adjusted. In June 2000, June 2001 and March 2003, an additional 211,500, 846,000 and 1,000,000 shares, respectively, were authorized. The Stock Incentive Plan provides for the granting of incentive stock options, non-qualified stock options, restricted stock and deferred stock to eligible participants. Options granted under the Stock Incentive Plan are for periods not to exceed ten years. Other than for options to purchase 133,445 shares granted in 2000 to certain employees which were vested immediately, options outstanding under the Stock Incentive Plan generally vest quarterly over two to four years. As of December 31, 2003, there were approximately 957,000 shares available for grant.

A summary of the activity of the Stock Incentive Plan is as follows:

	Options	Weighted-Average Exercise Price
Outstanding at December 31, 2000	1,461,296	$6.95
Granted below market	91,500	9.04
Granted at market	385,301	6.68
Forfeited	(71,791)	7.82
Exercised	(9,402)	2.65
Outstanding at December 31, 2001	1,856,904	6.98
Granted below market	—	—
Granted at market	769,050	7.94
Forfeited	(172,321)	6.75
Exercised	(40,271)	6.59
Outstanding at December 31, 2002	2,413,362	7.32
Granted below market	—	
Granted at market	429,236	4.63
Forfeited	(170,330)	7.79
Exercised	(124,205)	4.69
Outstanding at December 31, 2003	2,548,063	6.96
Exercisable at December 31, 2001	742,293	
Exercisable at December 31, 2002	1,238,493	
Exercisable at December 31, 2003	1,790,513	

Stock options outstanding at December 31, 2003 are summarized as follows:

Options Outstanding				Options Exercisable	
Exercise Price	Options Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Options Exercisable	Weighted-Average Exercise Price
$1.73–2.29	103,943	6.25	$1.86	103,943	$1.86
4.12 – 7.30	533,373	8.81	$4.96	306,673	$4.56
7.39	1,060,321	6.28	$7.39	990,922	$7.39
7.55 – 8.30	628,144	8.25	$7.92	241,106	$7.93
8.53 – 11.00	222,282	7.35	$9.41	147,869	$9.58
	2,548,063	7.39	$6.96	1,790,513	$6.84

During 2001 the Company granted 116,500 stock options to non-employee advisors and, using the fair value method, recorded compensation expense of approximately $151,000, $256,000 and $241,000 for the years ended December 31, 2003, 2002 and 2001, respectively.

11. Related Parties

Publisher

Random House, Inc., a holder of 1,780,131 shares of the Company's common stock at December 31, 2003, is also the publisher and distributor of certain of the Company's products. The contracts signed with Random House, Inc. typically contain an advance upon signing with the balance due upon delivery of the completed manuscript. During 2003 and 2002 the Company signed contracts with Random House, Inc. for zero and fifty-five new books, respectively. The total advances received at the time of the contracts for these books was $224,000 for the year ended December 31, 2002.

For the years ended December 31, 2003, 2002 and 2001, the Company earned $3.6, $3.5 and $2.5 million respectively, of book and publication income from Random House, Inc. Total receivables at December 31, 2003 and 2002 include $2.4 and $2.8 million, respectively, due from Random House, Inc. for royalties, book advances, copy editing and marketing fees. In addition, Random House, Inc. has paid advances of $48,000 and $34,000, respectively, to the Company for books that have not yet been completed as of December 31, 2003 and 2002, which are deferred as book advances. At December 31, 2002, the Company had a liability to Random House, Inc. of $141,000 for advances previously received on uncompleted books that were cancelled in 1999.

Franchisees

For the years ended December 31, 2003, 2002 and 2001, the Company earned revenues from its franchises for management services through royalties of approximately $4.2, $4.3 and $2.9 million, respectively, and earned revenues of $1.4, $1.6 and $2.3 million, respectively, through the sale of course materials. Included in accounts receivable at December 31, 2003 and 2002 was $1.4 million and $745,000, respectively, due from these franchises.

Loans to Officers

As of December 31, 2003 and 2002 the Company had loan balances to executive officers of approximately $1.2 million. No loans were made to executive officers after February 2002, although interest continues to accrue. Such amounts and accrued interest is included in other assets at December 31, 2003. These loans are payable in four consecutive, equal annual installments with the first payment to be made on the earlier of the fourth anniversary of the loan or 60 days after termination of

employment, accrue interest at 7.3% per year and as of December 31, 2003, are secured by the 299,066 shares of the Company's common stock owned by these officers.

12. Acquisitions

Princeton Review of Boston and Princeton Review of New Jersey

On March 2, 2001, the Company acquired the assets comprising the businesses of Princeton Review of Boston and Princeton Review of New Jersey for a total purchase price of approximately $13.8 million. The purchase price exceeded the fair value of the net assets acquired resulting in goodwill of approximately $12,918,000. Each of these entities provided test preparation courses under the Princeton Review name through one or more franchise agreements with the Company.

Approximately $10,175,000 of the purchase price was paid in cash at the time of closing and was financed through borrowings under the Company's credit facilities. The remaining $3,625,000 of the purchase price was paid by delivery to the sellers of two subordinated promissory notes (see Note 6).

Princeton Review Peninsula

On March 2, 2001, the Company acquired the assets of Princeton Review Peninsula, which provided test preparation courses in several counties in California under the Princeton Review name through a franchise agreement with the Company. The Company acquired the operations of Princeton Review Peninsula for a total cash purchase price of approximately $2.7 million, which it financed through borrowings under its credit facilities. The purchase price exceeded the fair value of the net assets acquired resulting in goodwill of approximately $2,599,000.

T.S.T.S.

On June 18, 2001, the Company acquired the assets of T.S.T.S. for a total purchase price of approximately $6.3 million. The purchase price exceeded the fair value of the net assets acquired resulting in goodwill of approximately $6,201,000. T.S.T.S. provided test preparation courses in Texas, Arizona, Oklahoma, Louisiana and New Mexico under the Princeton Review name through four franchise agreements with the Company.

Approximately $4.8 million of the purchase price was paid in cash at the time of closing and was financed through borrowings under the Company's credit facilities. The remaining approximately $1,475,000 of the purchase price was paid by delivery to the sellers of a subordinated promissory note (see Note 6).

The aforementioned acquisitions have been accounted for as purchases and have been included in the Company's operations from the date of the respective purchases.

Embark

On October 1, 2001, the Company completed its purchase of substantially all of the operating assets of Embark, a developer of online products and services for the college admissions market. Pursuant to an Asset Purchase Agreement, dated as of October 1, 2001, the Company, through its subsidiary Princeton Review Publishing, L.L.C., acquired Embark's college admissions business, which consists primarily of Embark's customer contracts with academic institutions and its technological platform for submitting electronic applications and related services.

The purchase price paid at closing for the Embark assets consisted of 875,000 newly issued shares of the Company's common stock valued at approximately $5.2 million, approximately $3.4 million in assumed indebtedness (see Note 6) and approximately $2.1 million in other assumed liabilities of

Embark, consisting primarily of deferred revenue relating to customer contracts assumed by the Company, net of acquired receivables of approximately $1 million. The purchase price, including acquisition costs of approximately $1,130,000, and earnout for 2001 of approximately $476,000, exceeded the fair value of net assets acquired, resulting in goodwill of approximately $7.2 million. The acquisition was recorded in accordance with FASB 141 and accordingly no amortization expense for goodwill related to this acquisition was recorded for 2001. In accordance with the earn-out provisions entitling Embark to additional consideration based on the performance of the acquired business, Embark earned a payment of 9,128 shares of our common stock and approximately $1.2 million in cash, based on the revenue performance of the acquired business through 2002, and received an additional $300,000 payment based on revenue performance for the first half of 2003. In addition to the purchase price, in connection with the transaction, the Company made a $1.8 million loan to Embark, which was secured by 300,000 of the shares of the Company's common stock that Embark received as part of the purchase price. The approximate $1.5 million earn-out was applied against the loan balance, which was repaid in full as of December 31, 2003.

The Princeton Review of St. Louis, Inc.

On October 18, 2002, the Company acquired the assets of The Princeton Review of St. Louis, Inc. for a total purchase price of approximately $850,000. The purchase price exceeded the fair value of the net assets acquired resulting in goodwill of approximately $750,000. The Princeton Review of St. Louis, Inc. provided test preparation courses in Missouri under the Princeton Review name through a franchise agreement with the Company. This acquisition has been accounted for as a purchase and has been included in the Company's operations from the date of the purchase.

Approximately $384,000 of the purchase price was paid in cash at the time of closing. Approximately $466,000 of the purchase price was paid by delivery to the sellers of a subordinated promissory note (see Note 6).

Princeton Review of North Carolina, Inc.

On July 11, 2003, the Company acquired a 77% interest in Princeton Review of North Carolina, Inc. and the remaining 23% was acquired on November 13, 2003. The total purchase price including both transactions was approximately $1,138,000, including imputed interest. The purchase price exceeded the fair value of the net assets acquired resulting in goodwill of approximately $938,000. Princeton Review of North Carolina, Inc. provided test preparation courses in North Carolina under the Princeton Review name through a franchise agreement with the Company. This acquisition has been accounted for as a purchase and has been included in the Company's operations from the date of the purchase.

Approximately $170,000 of the purchase price was paid in cash at the time of closings. The remaining approximately $968,000 of the purchase price was paid by delivery to the sellers of subordinated promissory notes (see Note 6).

The pro forma consolidated results of operations, assuming the consummation of the Princeton Review of Boston, Princeton Review of New Jersey, T.S.T.S. and Embark acquisitions as of January 1, 2001, are as follows (in thousands, except per share data):

	Year Ended December 31, 2001 (in thousands, except per share data)
Revenues	$ 81,037
Net loss	(13,204)
Net loss attributed to common stockholders	(14,468)
Basic and diluted net loss per share	$ (.82)

The pro forma effects of the Princeton Review Peninsula, The Princeton Review of St. Louis, and Princeton Review of North Carolina, Inc. Inc. are not presented above because their results are not significant.

13. Segment Reporting

The operating segments reported below are the segments of the Company for which separate financial information is available and for which operating results as measured by EBITDA are evaluated regularly by executive management in deciding how to allocate resources and in assessing performance. The accounting policies of the business segments are the same as those described in the summary of significant accounting policies (See Note 1).

The following segment results include the allocation of certain information technology costs, accounting services, executive management costs, office facilities expenses, human resources expenses and other shared services which are allocated based on consumption. Corporate consists of unallocated administrative support functions. The Company operates its business through three divisions. The majority of the Company's revenue is earned by the Test Preparation Services division, which sells a range of services including test preparation, tutoring and academic counseling. Test Preparation Services derives its revenue from Company operated locations and from royalties from and product sales to independently owned franchises. The Admissions Services division earns revenue from subscription, transaction and marketing fees from higher education institutions and from selling advertising and sponsorships. The K-12 Services division earns fees from assessment, remediation and professional development services it renders to K-12 schools and from its content development work. Additionally, each division earns royalties and other fees from sales of its books published by Random House. Beginning January 1, 2003, the Company changed the reporting of certain revenue earned from the sales of books which was previously included in the Admissions Services segment to each of the segments based on the relevance of the book to that segment. In connection with this change, the Company reclassified prior years.

The segment results include EBITDA for the periods indicated. As used in this report, EBITDA means earnings before interest, income taxes, depreciation and amortization. The Company believes that EBITDA, a non-GAAP financial measure, represents a useful measure of evaluating its financial performance because it reflects earnings trends without the impact of certain non-cash and non-operations-related charges or income. The Company's management uses EBITDA to measure the operating profits or losses of the business. Analysts, investors and rating agencies frequently use EBITDA in the evaluation of companies, but the Company's presentation of EBITDA is not necessarily comparable to other similarly titled measures of other companies because of potential inconsistencies in the method of calculation. EBITDA is not intended as an alternative to net income as an indicator of the Company's operating performance, nor as an alternative to any other measure of performance calculated in conformity with GAAP.

THE PRINCETON REVIEW, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements — (Continued)

(In thousands)

Year Ended December 31, 2003	Test Preparation Services	K-12 Services	Admissions Services	Corporate	Total
Revenue	$71,719	$21,525	$11,218	—	$104,462
Operating Expenses (including depreciation and amortization)	38,026	13,986	10,822	$ 1,703	64,537
Segment Assets	33,908	20,189	29,728	37,872	121,697
Segment Goodwill	22,991	—	8,699	7,890	39,580
Expenditures for long lived assets	2,103	2,644	1,249	1,493	7,489
Segment operating income (loss)	11,787	(789)	(2,440)	(1,703)	6,855
Depreciation & Amortization	1,522	1,594	1,760	1,161	6,037
Other	—	—	(32)	—	(32)
Segment EBITDA	$13,309	$ 805	$ (712)	$ (542)	$ 12,860

Year Ended December 31, 2002	Test Preparation Services	K-12 Services	Admissions Services	Corporate	Total
Revenue	$67,930	$10,066	$11,240	—	$ 89,236
Operating Expenses (including depreciation and amortization)	36,121	11,916	14,956	$ 1,704	64,697
Segment Assets	32,565	12,740	26,611	40,200	112,116
Segment Goodwill	21,861	—	8,406	7,890	38,157
Expenditures for long lived assets	2,934	2,873	1,288	2,828	9,923
Segment operating income (loss)	12,163	(5,382)	(6,604)	(1,704)	(1,527)
Depreciation & Amortization	1,804	1,262	2,136	1,067	6,269
Other	—	—	(122)	—	(122)
Segment EBITDA	$13,967	$(4,120)	$(4,590)	$ (637)	$ 4,620

Year Ended December 31, 2001	Test Preparation Services	K-12 Services	Admissions Services	Corporate	Total
Revenue	$55,340	$ 6,885	$ 6,890	—	$ 69,115
Operating Expenses (including depreciation and amortization)	35,670	11,625	12,093	$ 4,735	64,123
Segment Assets	28,467	6,837	30,213	46,316	111,833
Segment Goodwill	20,791	—	7,206	7,890	35,887
Expenditures for long lived assets	24,650	2,185	13,846	784	41,465
Segment operating income (loss)	2,061	(7,222)	(6,855)	(4,735)	(16,751)
Depreciation & Amortization	2,851	1,172	1,481	975	6,479
Other	12	—	(45)	—	(33)
Segment EBITDA	$ 4,924	$(6,050)	$(5,419)	$(3,760)	$(10,305)

THE PRINCETON REVIEW, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements—(Continued)

	Years Ended December 31, 2003	2002	2001
Reconciliation of operating loss to net loss			
Total income (loss) for reportable segments	$ 6,855	$(1,527)	$(16,751)
Unallocated amounts:			
Interest expense	(607)	(624)	(2,043)
Other income	1,217	325	536
(Provision) benefit for income taxes	(3,156)	736	7,924
Net income (loss)	$ 4,309	$(1,090)	$(10,334)

14. Quarterly Results of Operations (Unaudited)

The following table presents unaudited statement of operations data for each of the eight quarters in the two year period ended December 31, 2003. This information has been derived from the Company's historical consolidated financial statements and should be read in conjunction with the Company's historical consolidated financial statements and related notes appearing in this Annual Report on Form 10-K.

	Quarter Ended Mar. 31, 2002	June 30, 2002	Sept. 30, 2002	Dec. 31, 2002	Mar. 31, 2003	June 30, 2003	Sept. 30, 2003	Dec. 31, 2003
	(in thousands, except per share data)							
Revenue								
Test Preparation Services	$14,826	$15,773	$23,228	$14,103	$16,030	$16,448	$25,045	$14,196
K-12 Services	1,365	2,966	2,279	3,456	2,990	5,124	3,959	9,452
Admissions Services	3,206	2,310	2,212	3,512	2,674	2,123	3,000	3,421
Total revenue	19,397	21,049	27,719	21,071	21,694	23,695	32,004	27,069
Cost of revenue								
Test Preparation Services	4,620	4,578	6,106	4,341	4,501	5,698	6,983	4,724
K-12 Services	354	832	950	1,397	1,211	1,445	1,871	3,801
Admissions Services	660	600	779	849	908	470	812	646
Total cost of revenue	5,634	6,010	7,835	6,587	6,620	7,613	9,666	9,171
Gross profit	13,763	15,039	19,884	14,484	15,074	16,082	22,338	17,898
Operating expenses								
Selling, general and administrative	17,616	15,773	17,431	13,533	17,051	15,401	16,995	15,090
Impairment of investment	—			344	—	—	—	—
Total operating expenses	17,616	15,773	17,431	13,877	17,051	15,401	16,995	15,090
Income (loss) from operations	(3,853)	(734)	2,453	607	(1,977)	681	5,343	2,808
Net income (loss)	$(2,254)	$ (434)	$ 1,316	$ 282	$(1,203)	$ 299	$ 3,071	$ 2,142
Basic income (loss) per share	$ (0.08)	$ (0.02)	$ 0.05	$ 0.01	$ (0.04)	$ 0.01	$ 0.11	$ 0.08
Diluted income (loss) per share	$ (0.08)	$ (0.02)	$ 0.05	$ 0.01	$ (0.04)	$ 0.01	$ 0.11	$ 0.08
Weighted average shares used in computing net income (loss) per share								
Basic	27,187	27,248	27,259	27,262	27,272	27,282	27,317	27,358
Diluted	27,187	27,248	27,381	27,349	27,272	27,425	27,527	27,661

15. Earnings (Loss) Per Share

The following table sets forth the denominators used in computing basic and diluted earnings (loss) per common share for the periods indicated:

	Years Ended December 31,		
	2003	2002	2001
		(in thousands)	
Weighted average common shares outstanding			
Basic	27,306	27,239	21,383
Net effect of dilutive stock options-based on the treasury stock method	152	—	—
Other	9	—	—
Diluted	27,467	27,239	21,383

For the year ended December 31, 2002, 135,916 stock options were excluded from the computation of diluted earnings per common share due to their antidilutive effect. For the year ended December 31, 2001, warrants for 249,773 shares of common stock and 3,748,548 shares of convertible preferred stock were excluded from the computation of diluted earnings per common share due to their antidilutive effect.

EXHIBIT C

LIST OF U.S. FRANCHISEES